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IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

KANSAS GAS AND ELECTRIC COMPANY,
Appellant,

V.

STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS,
Appellee.

KANSAS CITY POWER & LIGHT COMPANY,
Appellant,

V.

STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS,
Appellee.

On Appeal from the Supreme Court of Kansas

BRIEF OF AMICUS CURIAE, THE LEGAL FOUNDATION OF AMERICA, URGING REVERSAL

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BRIEF OF AMICUS CURIAE, THE LEGAL FOUNDATION OF AMERICA, URGING REVERSAL

INTEREST OF AMICUS CURIAE

The Legal Foundation of America ("LFA") is a nonprofit corporation supporting the operations of a public interest law firm. Its goals include enhancement of the market system of resource allocation, the attainment of a better balance between the federal government and the states, and the preservation of a rational system of criminal justice. In support of these goals, the attorneys representing LFA have appeared as amicus curiae in the United States Supreme Court, in the federal courts of

appeals, in the federal district courts, and in the courts of various states. All litigation undertaken by LFA is approved by its Board of Directors, the majority of whom are attorneys.

LFA has particular expertise in the presentation of economic concepts and issues of regulatory policy to courts. One of LFA's attorneys has served as an expert witness in federal court to explain the energy market.

In the case at bar, LFA wishes to present to the Court a single issue that is at the heart of the case: whether a regulated public utility should recoup investment that a regulatory body later deems excessive, or whether stockholders should share losses attributable to such investment.

SUMMARY OF ARGUMENT

Lurking behind many of the arguments in this case is the following contention: that since in this case the utility made investment in a nuclear facility which in hindsight the Kansas Corporation Commission ("KCC") considered excessive, the cost of the "excess" investment should be borne by the utilities and their stockholders. Since the utilities are in business, and since ordinary, non-regulated business entities do not recoup excessively costly investments, these utilities should not either—so the argument goes.

This argument, though superficially appealing, is erroneous. It fails to take into account differences between unregulated private enterprises and regulated public utilities. Economists are in general agreement that a regulated public utility cannot at one and the same time be confined to regulated profit on successful activities and be required to sustain the loss of unproductive ones, without impairment of fiscal integrity. Since the *Hope* test requires inquiry into "the financial integrity of the company whose rates are being regulated," *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), this economic analysis is essential to the decision of this case.

For reasons given below, the costs attributable to regulated investment can only be reviewed rationally in the context of original costs. This concept does not mean that a utility recovers any expenditure, no matter how imprudent; if a particular investment, at the time it is incurred, is so culpably imprudent that it cannot be characterized as part of long run average costs, then it should not be part of the rate base. This test of culpable imprudence should be the determinant of inclusion of non-productive investment in the rate base, rather than the concept of placing costs on utility investors by hindsight. If these concepts accurately are applied to the present case, it becomes clear that the decisions below effect an unconstitutional taking.

ARGUMENT

I. THE *HOPE* TEST REQUIRES INQUIRY INTO "THE FINANCIAL INTEGRITY OF THE COMPANY WHOSE RATES ARE BEING REGULATED." THE ECONOMIC ANALYSIS IN THIS BRIEF IS A NECESSARY COMPONENT OF THAT INQUIRY.

In *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944), the Court mandated inquiry into the "financial integrity of the company whose rates are being regulated." A rate order is "unjust and unreasonable in its consequences" if it does not allow a sufficient return "to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital." *Id.* at 602. *See also In re Permian Basin Area Rate Cases*, 390 U.S. 747, 770 (1968).

This inquiry necessarily includes the kind of analysis done in this brief of amicus curiae. In passing, amicus would add that a rate providing a return of less than one percent to common shareholders, see Jurisdictional Statement of Kansas Gas & Electric Co. at 12, is highly unlikely on its face to be justified. However, the analysis contained here is concerned with the consequences of that rate, which *Hope* and *Permian* indicate are the most important concern.

II. COSTS OF INVESTMENT SHOULD NOT BE BORNE BY UTILITY INVESTORS MERELY BECAUSE THEY ARE DEEMED "EXCESSIVE" IN HINDSIGHT. SUCH AN APPROACH WOULD IGNORE THE ABSENCE OF GREATER-THAN-NORMAL PROFITS IN A REGULATED UTILITY AND WOULD IMPAIR THE FISCAL INTEGRITY OF THE UTILITY.

Prices in non-regulated, competitive industries are set by the market itself. Each single unit of production tends to be compensated proportionally to its capacity for actual service in the marketplace. However, economists are in general agreement that this concept cannot be applied to selected units of a public utility that is regulated on an original-cost basis. For example, the following is given by R. DORFMAN, PRICES AND MARKETS 153 (Harv. 3rd ed. 1978) (emphasis added):

> [If a regulated public utility] were to *charge a price . . . as a competitor does, [it] would be losing money.* No matter how economists may extol the virtues of . . . charging for each unit of a product the addition to costs attributable to it . . . , the [regulated public utility] cannot afford to follow that policy.

In other words, the net result of the argument that equity investors in a public utility should bear what a regulatory body later determines are "excess" costs *would be to cause all such utilities to lose money in the long run.* That fallacious reasoning is precisely what supports the conclusion of the Kansas Corporation Commission here. If it prices some units by disallowing "excess" costs, it could not ensure financial integrity without also allowing very high returns on other units; but that approach is fundamentally contrary to the concept of cost-based rate regulation.

The main reason for this difference between regulated public utilities and non-regulated competitive industries is explained by the following:

> The actual profit rate on a particular investment can diverge from the long-term normal rate for several reasons. In a particular year, errors in short-run planning or prediction may lead sellers to under- or over-estimate the demand for their products, and this in turn, may yield higher or lower prices or profits than expected. Such deviations in profits from the norm are called windfalls. . . . But positive and negative windfalls should about cancel out over the long pull. They should not distort long-run normal profits.

R. CAVES, AMERICAN INDUSTRY: STRUCTURE, CONDUCT, PERFORMANCE (Harv. 5th ed. 1982). This description fits the competitive, non-regulated enterprise. However, a regulated public utility cannot offset losses against "windfalls" occurring in "good" years, because its rate of return is regulated. As Kansas Gas & Electric Co. colorfully put it in its Jurisdictional Statement at 9, "[U]tility investors do not have the opportunity to earn the profits Ford earned on the Mustang because they do not risk the losses Ford incurred on the Edsel." Even if it invests astutely in a given "good" year or in a given plant, a utility is prohibited from receiving more than a regulated profit in that year or on that plant, and consequently, it cannot offset greater-than-normal profits against losses.

For this reason, regulatory agencies usually focus upon a utility's "original" costs. "A regulatory agency might . . . [interpret] costs to include a reasonable return on invested capital; and this is often done." R. DORFMAN, *supra*, at 152-53. Thus the test should be whether the item is properly includable in original costs. *Id.*

If a particular managerial decision, viewed as of the time it is made, is so culpably imprudent that no reasonable manager

would have made such a decision as of that time, the costs so incurred are not to be considered a part of long run average costs and should not be included in the rate base. However, this concept must be applied with caution. It must be understood that there is a range of decisions that can be made, and that the choice among those decisions is to be understood in light of information available at the time, not in the light of hindsight. If hindsight is used, the disadvantageous result described above will occur: all losses will be placed upon the investor, those losses cannot be offset against greater-than-usual profits, and the fiscal integrity of the utility will be impaired.

It is particularly difficult to judge management's energy forecasts fairly when the actual outcome is known. Hindsight may interfere with comprehension of past expectations, even if an effort to the contrary is made. For example, in the early 1970's, many utilities that depended on fuel oil were suddenly left without supplies, and a few years later, some parts of the country dependent upon natural gas experienced severe shortages. In fact, the utilities in the case at bar faced precisely such shortages at relevant times. More recently, the Power Plant and Industrial Fuel Use Act (PIFUA), 42 U.S.C. sec. 8301 et seq. (West Supp. 1980), has inhibited planning for uses of natural gas as a boiler fuel, and the Department of Energy vigorously encouraged utilities to shift from natural gas to other fuels, including nuclear energy. DOE, *National Energy Plan II* (1979); *see also* DOE, *Reducing U.S. Oil Vulnerability: Energy Policy for the 1980's* (1980); ERDA, *Energy in Transition: 1985-2010* (1979). Thus the evaluation of forecasts of future energy supplies from a perspective of subsequent events may engender allegations of "excessive" costs even when there has been good-faith and indeed prudent management.

Consequently, if the evidence in this case supported a finding of culpable negligence in management, the costs produced thereby would not properly be included in the rate base. But this test should not be satisfied by the mere fact that "excessive" investment has been undertaken. If there is no actual evidence of culpable imprudence, the results of such decisions should be

included in the rate base. In this case, ninety percent of the utility's expenditures (and one hundred percent of those here at issue) have been recognized as prudent. The disallowance of major parts of those prudent expenditures amounts to a taking of property without compensation.

CONCLUSION

If it is to be faithful to the Constitution, this Court cannot permit the approach of placing costs attributable to the operations of a regulated public utility on equity shareholders merely because they are deemed excessive in hindsight. Unregulated competitive enterprises can offset reduced receipts by greater-than-normal profits in "good" years, but a regulated public utility cannot do so because its profits even in "good" years are regulated. Consequently, the approach of causing equity shareholders to bear the costs of a public utility's "excess capacity" as a general proposition, inescapably would lead to impairment of the utility's financial integrity. It therefore would violate the *Hope* test. Only if a particular investment or cost is so culpably imprudent that it cannot rationally be included in the original cost of the operation of a utility over the long run, should it be excluded from the rate base; absent actual proof of culpable imprudence, it should be included.

Respectfully submitted,

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